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TAGS: EFIN ECON GH
SUBJECT: GHANA CENTRAL BANK'S NEW MONETARY POLICY FRAMEWORK: IMPACT ON THE FINANCIAL SECTOR

Summary

¶1. (SBU) The Bank of Ghana (BoG) instituted a new monetary policy framework on July 1 -- including reduced reserve requirements -- to move towards an inflation targeting regime, increase transparency, and make the financial sector more competitive. Despite the potential expansionary effect of the new policy, the BoG is confident it is controlling inflation and is positioned to handle any external shocks. Private banks applauded the policy shift and say it should spur lending. However, they complain of constraints such as labor costs and an inadequate legal system that increase risks and lead to high lending rates. End Summary

Bank of Ghana's New Monetary Policy Framework

¶2. (SBU) On July 1, the BoG unveiled its new monetary policy framework, which aims to create a more transparent, efficient and competitive financial sector, develop a secondary market in government securities, and encourage banks to expand the inter-bank lending market. The BoG will lessen its focus on controlling the money supply and will focus more on using the Prime Rate and other BoG lending instruments to control inflation and signal the direction of short-term interest rates.

¶3. (SBU) The key element of the new framework is the reduction of the secondary reserve requirement (RR) on deposits from the current level of 35% -- high compared to Ghana's peers -- to 15%. (Note: banks' primary RR of 9% is deposited in non-interest bearing accounts at the BoG, while the secondary RR must be held in a mix of long and short term government securities. End Note). Another key aspect is that the BoG will separate Open Market Operations (OMO) from Public Sector Borrowing Requirement (PSBR) operations, which should make for more transparent BoG signaling to the financial markets.

¶4. (SBU) BoG Governor Paul Acquah's top policy advisor, Dr. Mahamudu Bawumia, commented to econoffs that the high secondary RR contributed to disintermediation and high rate spreads (between deposits and loans) in the banking system. Conversely, lowering the RR should increase available funds banks have to lend to the private sector, which should result in greater competition and lower lending rates.

¶5. (SBU) The framework also includes the introduction of overnight REPO and reverse-REPO facilities, designed to deepen and improve the transparency of inter-bank markets, and give banks incentive to use the inter-bank market to solve their liquidity problems. The BoG also intends to increase transparency by providing continuously updated information on inter-bank market transactions through Reuters. Finally, the BoG will facilitate development of the non-cash payments system by requiring all banks to use the Visa Payments (ATM) Platform.

Private Banks' Views

¶6. (SBU) Ghana's banks have been among the most profitable in sub-Saharan Africa, largely as a result of earnings on their holdings of high-interest government T-Bills and large spreads between deposit and loan rates. According to a 2005 BoG survey, interest rate spreads in Ghana were among the highest in Africa in 2004, with average deposit rates of 7.5% and average lending rates of 28.8%. The spread has narrowed over the last year as T-Bill rates fell, but is still significantly larger than in any of Ghana's peer countries.

¶7. (SBU) The high lending rates are a main reason for relatively limited lending to the private sector. However, banks point out that the GoG traditionally absorbed much of the available credit through the high reserve requirements, which acted as an implicit financial tax. Furthermore, the BoG capped bank fees, which encouraged banks to boost returns through higher lending rates. (Note: The BoG study also reports evidence of oligopolistic behavior among Ghanaian banks, with five banks controlling 70% of total assets and little evidence of competition in fee pricing or interest rates. End Note)

¶8. (SBU) Bankers agree that the lower RR will increase their

liquidity and should result in more lending to the private sector. However, they point to other factors that raise both costs and risks for banking in Ghana. Banks' labor costs average over 55% of overhead costs and are a major contributor to the large loan-deposit rate spread. Banks also point to the lack of an effective land titling system, high costs of foreclosure, and inadequate legal and regulatory structure as main components of high risk premiums -- resulting in higher rates and fees. They also have a legitimate claim that the difficult macroeconomic environment from 2000-2004 discouraged lending. Finally, banks have tapped out blue chip customers so most new lending will go to SMEs. Given inherent risks in SME lending, as loans to this sector increase over the next few years many in the industry expect the non-performing loan ratio to increase.

BoG Comments on Inflation Concerns

¶9. (SBU) Some observers have commented critically on the timing of this initiative, given pressures from high fuel costs on inflation and following on the heels of the BoG's expansionary policy decision in May to lower the Prime Rate from 18.5% to 16.5%. Dr. Bawumia admits that the lower RR will increase the money supply over the medium term, which may create an excess liquidity problem for the BoG to deal with. Nevertheless, he notes that BoG officials are confident the economy has absorbed February's 50% fuel price hike and inflation is on a downward trend.

¶10. (SBU) Dr. Bawumia also argues that the BoG is better equipped to handle the impact of future shocks, such as further fuel price increases, with its separate Open Market Operations, and with the BoG's two new OMO tools: 28 and 56 day T-bills. Bawumia even comments that the BoG's medium term goal is to relax BoG oversight even further by eliminating the secondary reserve requirement altogether. The BoG is also drafting a new foreign exchange law that will liberalize the entire financial sector, eliminating capital controls and opening up opportunities for foreign currency and off-shore lending.

Comment

¶11. (SBU) Banks have been vocal for years with their complaints about the high reserve requirements on deposits, and have used it as the main justification for their high lending rates and relatively limited lending to the private sector. Now that they have their wish, it is put up or shut up time. However, if an upward trend in private sector lending does not develop over the second half of 2005, we can expect calls from the private sector and even government ministries for the BoG to increase pressure on the banking system. End Comment.
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